A Great Economic Experiment

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On February 15, 1999, Robert Rubin, Alan Greenspan and Lawrence Summers appeared on the cover of *Time* magazine with the title, "The Committee to Save the World: The inside story of how the Three Marketeers have prevented a global economic meltdown – so far." At the time, Russia, Asia and Latin America were in turmoil. According to the author, "In the past 18 months 40% of the world's economies have been tugged from robust growth into recession or depression." Yet the U.S. economy stood above the fray, boasting growth of over 5% and the lowest unemployment rate in 28 years. Gushing about the pragmatism, intellect and humility of the three members at Treasury and the Federal Reserve, *Time* was not stingy about giving credit:

February 15, 1999

> To help resolve the riddle of imperfect markets, the committee has spent six years working on an experiment. It's called the U.S. economy. The current boom is as much a part of the committee's legacy as is its battle to stem global turmoil.... The men don't get all the credit for the boom – they're the first to say all they did was let the markets work – but on both Wall Street and Pennsylvania Avenue, they get the bulk of it. Their success has turned them into a kind of free-market Politburo on economic matters.

The iconic *Time* magazine puff piece revealed a mindset that would dominate the economy and markets ever since: The financial elites would run things. Their primary tools would be monetary stimulus and systemic safety nets. If all went according to plan they would take credit; if not, they would blame capitalism. Either way, their power would expand. And if they failed to see around corners, they would claim no one could.

The modern-day seeds of the interventionist mentality were planted during the Progressive Era of the early 1900s which ushered in the income tax, Federal Reserve System, Prohibition, and America's disastrous entry into WWI. First, the Fed's meddlers set out to smooth the boom-bust cycle by expanding credit and "stabilizing the price level." As the 1920s boom ensued, they unwittingly turned speculators loose by creating the illusion of a safety net for investors. According to *Financial World* of April 10, 1029:

> It may be well again to stress the all-important point that the Federal Reserve has it in its power to change interest rates downward any time it sees fit to do so and thus to stimulate business.

The leading pied piper of the day was Irving Fisher, professor of political economy at Yale and interventionist to the core. Fisher received the first Ph.D. in economics at Yale in 1891, studied in Berlin and Paris, was a proponent of Prohibition and eugenics, and co-founded the Econometric Society in 1930. Two days after the bull market peak, he had no inkling of the storm that was about to hit:

> There may be a recession in stock prices, but not anything in the nature of a crash. Dividend returns on stocks are moving higher. This is not due to receding prices for stocks, and will not be hastened by any anticipated crash, the possibility of which I fail to see.

Unfortunately, his misguided belief system cost him most of his private wealth and reputation in the 1929 Crash.

Act II in this Greek tragedy was the government's uncharacteristic response to the stock market crash. In a speech to the Chamber of Commerce on May 1, 1930, President Herbert Hoover boasted of his departure from the longstanding policy not to interfere with a boom's liquidation:

> On the occasion of this great storm we have for the first time attempted *a great economic experiment*, possibly one of the greatest of our history.... We have avoided monetary panic and credit stringency. Those dangers are behind us. From the moment of the crash, interest rates have steadily decreased and capital has become steadily more abundant [emphasis mine].

Austrian economist Hans Sennholz recounts the Fed's aggressive actions:

> [Hoover] prodded the Federal Reserve to renew many of the money illusions of the 1920s. The New York Federal Reserve Bank lowered its discount rate, ½% at a time, from 4½% on February 6, 1930, to 2% by the end of 1931. It cut its buying rate for acceptances to 1¾%. Trying desperately to reignite the boom, the System bought government securities on a grand scale, $729.467 million in 1930 and $816.96 million in 1932.

At the time (1932), Friedrich Hayek wrote:

> Instead of furthering the inevitable liquidation of the maladjustments brought about by the boom during the last three years, all conceivable means have been used to prevent that readjustment from taking place; and one of these means, which has been repeatedly tried

though without success, from the earliest to the most recent stages of depression, has been this deliberate policy of credit expansion....

To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about; because we are suffering from a misdirection of production, we want to create further misdirection – a procedure that can only lead to a much more severe crisis as soon as the credit expansion comes to an end.... It is probably to this experiment, together with the attempts to prevent liquidation once the crisis had come, that we owe the exceptional severity and duration of the depression.

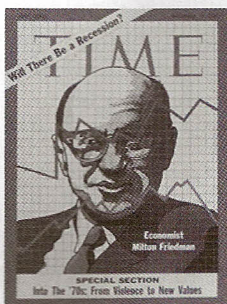
The greatest economic experiment in American history culminated in its worst catastrophe, with lessons laid bare for future generations. The hubris of men in ivory towers pulling economic levers was over, end of story....

... Not so fast. Irving Fisher was not buried; his work inspired a young economist named Milton Friedman, was revived in the 1950s, and laid the groundwork for monetarism. (Friedman and Nobel laureate James Tobin referred to Fisher as "the greatest economist the United States ever produced.") In 1963, at the suggestion of Arthur Burns, Friedman and Anna Schwartz collaborated to write *A Monetary History of the United States*. Contrary to the accepted wisdom of the day which (wrongly) blamed the Great Depression on animal spirits and a loss of confidence, the two largely fingered Federal Reserve incompetence. Friedman later wrote in *Two Lucky People*:

The Fed was largely responsible for converting what might have been a garden-variety recession, although perhaps a fairly severe one, into a major catastrophe. Instead of using its powers to offset the depression, it presided over a decline in the quantity of money by one-third from 1929 to 1933.... Far from the depression being a failure of the free-enterprise system, it was a tragic failure of government.

Using a semantic trick, Friedman turned "failure of government to intervene even further" into "failure of government." This was a statist's dream. What better pitchman for government intrusion than a champion of free markets with an uncanny ability to explain economics in layman's terms? On December 19, 1969, Friedman graced the cover of *Time* magazine:

The philosophy of Keynes, who died in 1946, has dominated the economic policies of industrial nations since World War II. Today's prevailing belief, however, is a hybrid; most economists now consider themselves "Friedmanesque Keynesians." Having risen from maverick to messiah, Friedman ranks with Walter Heller and John Kenneth Galbraith as one of the most influential U.S. economists of the era.



December 19, 1969

In 1971 Austrian economist Murray Rothbard smelled a rat, writing in *The Individualist*:

Mention "free-market economics" to a member of the lay public and chances are that if he has heard the term at all, he identifies it completely with the name Milton Friedman. For several years, Professor Friedman has won continuing honors from the press and the profession alike, and a school of Friedmanites and "monetarists" has arisen in seeming challenge to the Keynesian orthodoxy.

However, instead of the common response of reverence and awe for "one of our own who has made it," libertarians should greet the whole affair with deep suspicion: "If he's so devoted a libertarian, how come he's a favorite of the Establishment?" An advisor of Richard Nixon and a friend and associate of most Administration economists, Friedman has, in fact, made his mark in current policy, and indeed reciprocates as a sort of leading unofficial apologist for Nixonite policy.

In fact, in this as in other such cases, suspicion is precisely the right response for the libertarian, for Professor Friedman's particular brand of "free-market economics" is hardly calculated to ruffle the feathers of the powers-that-be. Milton Friedman is the Establishment's Court Libertarian, and it is high time that libertarians awaken to this fact of life.

The 1969 *Time* article continues:

Milton Friedman's opinions have particular weight now because the Nixon Administration has placed great reliance on the policies that he prescribes to deal with the current inflation.... Ironically, Friedman's principal complaint is that the Federal Reserve is overdoing the restraints in its effort to cure inflation. "If the board continues to keep the growth of money at zero for another two months, I find it hard to see how we can avoid a severe recession," he says. "The board has made the same mistake that it has made all along. It is going too far in the right direction."

Milton Friedman gravely miscalculated, giving intellectual cover to the inflationary 1970s while his undergraduate economics professor, Arthur Burns, manned the printing press.

More hubris, more lever pulling, and yet these statist ideas could not be swept into the dustbin of history.

Instead, they thrived in academia where a new generation of meddlers and tinkerers who embraced them were handpicked and promoted by the Establishment. At a conference to honor Milton Friedman on his 90th birthday in 2002, just days into his new job as Fed Governor, a 49-year-old Princeton economics professor named Ben Bernanke said, "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

As if to prove his 1970s inflation blunder was no fluke, Milton Friedman fully endorsed the post-tech bubble Greenspan experiment in a January 31, 2006 *Wall Street Journal* op-ed:

> It has long been an open question whether central banks have the technical ability to maintain stable prices. Their repeated failures to do so suggested that they did not – whence, in part, my preference for rigid rules. Alan Greenspan's great achievement is to have demonstrated that it is possible to maintain stable prices. He has set a standard.

Predictably, after the credit bubble imploded in 2008, Treasury Secretary Timothy Geithner, testifying about the AIG bailout, went straight to the Friedmanite playbook: "To stand back and let it burn is irresponsible. It's what happened in the Great Depression."

This brings us to the latest iteration of the great U.S. economic experiment. The Greenspan Doctrine has been replaced by the more aggressive Bernanke Doctrine, to be replaced by the hyper aggressive Yellen Doctrine. Greenspan's "New Economy" bubble of 2000 was not fully liquidated; instead the Fed funds rate was lowered from 6½% to 1¾% over a two-year period, planting the seeds of a housing and credit bubble that peaked in 2007. When that bubble burst, Bernanke wrote the same prescription, but upped the dose: bailouts for the political class, a tripling of the Fed's balance sheet, and a Fed funds rate below 0.25% for nearly five straight years (Figure 1). His successor, Janet Yellen, went to the same medical school and now plans to keep the economy addicted to ZIRP at least until 2017.

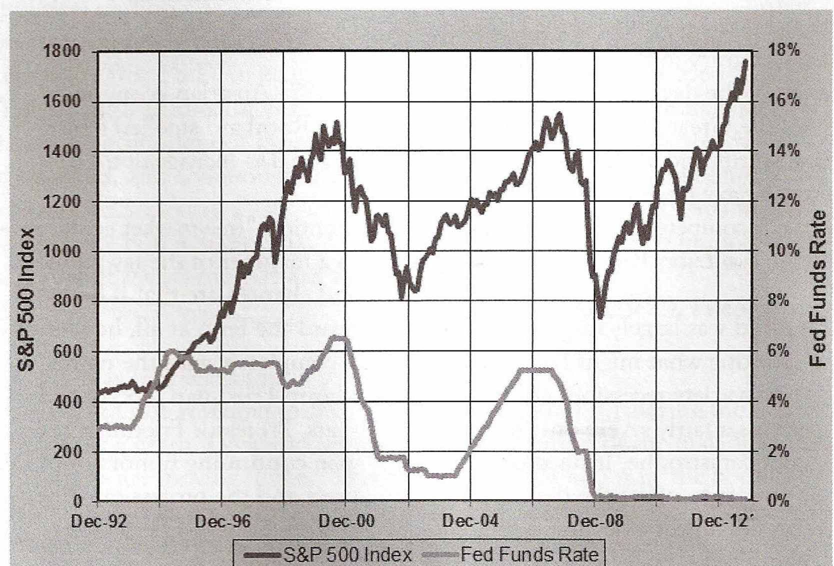
The current stimulus and sovereign debt bubble is truly one for the ages, having passed the credit bubble in magnitude and duration (Table 1). Besides the Fed as backstop, rationalizations abound for why the asset boom will continue. "Plenty of cash on the sidelines," "strong corporate balance sheets," and "restrained sentiment" are myths that, repeated often enough, become gospel. The truth is that equity fund cash levels are at just 3.6%, money market fund balances stand at record low levels relative to mutual fund and ETF assets (Figure 2), corporations are taking on debt to buy back shares, and investor sentiment is arguably more bullish than the 2007 top and near the euphoria of 2000 (Figure 3).

The prototypical advocate of the current boom (Table 2) went to an Ivy League school, majored in economics or business, and graduated in the 1970s. In all likelihood he was imbibing the monetarist Kool-Aid that was flowing at these elite institutions. He has risen to the top of his field, controls or influences billions or trillions of dollars in assets, and has become fabulously wealthy. Is he prepared for the rules of the financial game to radically change? In *Fooled by Randomness*, Nassim Taleb describes a phenomenon called "survival of the least fit:"

> Just as an animal could have survived because its sample path was lucky, the "best" operators in a given business can come from a subset of operators who survived because of over-fitness to a sample path – a sample path that was free of the evolutionary rare event. One vicious attribute is that the longer these animals can go without encountering the rare event, the more vulnerable they will be to it.

As with their previous experiments, the Fed's mad scientists are constantly surprised when they blow the roof off the laboratory. In fact, they may be so backwardly wired to have predictive value. In April 2000 (one month after the NASDAQ peak), Alan Greenspan was asked if rising rates would prick the stock market bubble. His response: "That presupposes I know that there is a bubble.... I don't think we can know there's a bubble until after the fact." In July 2005, Ben Bernanke felt, "Unquestionably housing prices are going up quite a bit, but I would

Figure 1 **Fed Funds Rate, 1993–2013**



Source: www.federalreserve.gov

Table 1 **Three Bubbles in 19 Years**

Start Date	End Date	Description	S&P 500 Gain	Duration
12/8/1994	9/1/2000	Technology bubble	+241%	5.74 years
3/11/2003	10/9/2007	Housing and credit bubble	+95%	4.61 years
3/9/2009	?	Stimulus and sovereign debt bubble	+165%	4.69 years

Table 2 **Pied Pipers of the Stimulus Bubble**

Name	Age	Employer	Elite Education	Highest Degree	Year Graduated
Bernanke, Ben	60	Federal Reserve	Harvard, MIT	Ph.D., economics	1979
Blankfein, Lloyd	60	Goldman Sachs	Harvard	J.D.	1978
Buffett, Warren	83	Berkshire Hathaway	Wharton, Columbia	M.S., economics	1951
Cramer, Jim	58	CNBC	Harvard	J.D.	1977
Dalio, Ray	64	Bridgewater Assoc.	Harvard	MBA	1972
Dimon, Jamie	57	JPMorgan Chase	Tufts, Harvard	MBA	1982
Fink, Larry	61	BlackRock		MBA	1976
Fisher, Ken	63	Fisher Investments		A.B, economics	1972
Gross, Bill	69	Pimco	Duke	MBA	1971
Kudlow, Larry	66	CNBC	Princeton	A.B., history	1969
Siegel, Jeremy	68	Wharton School	Columbia, MIT	Ph.D., economics	1971
Tepper, David	56	Appaloosa Mgt.	Carnegie Mellon	MBA	1982

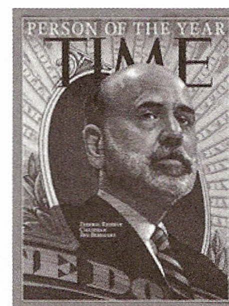
Source: www.wikipedia.org

note that the fundamentals are very strong." By October 2006, Greenspan thought, "Most of the negatives in housing are probably behind us." In early 2007, Bernanke assured us: "The impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained," while Janet Yellen said, "So far, there's been remarkably little effect [from housing] on the rest of the economy."

Today, Janet Yellen sees no "risks to financial stability" and limited evidence of "reach-for-yield" or excessive leverage. Citing several valuation measures, she claims "you would not see stock prices in territory that would suggest ... bubble-like conditions."

At the end of 2009, Milton Friedman's disciple, Ben Bernanke, was voted *Time*'s "Person of the Year:"

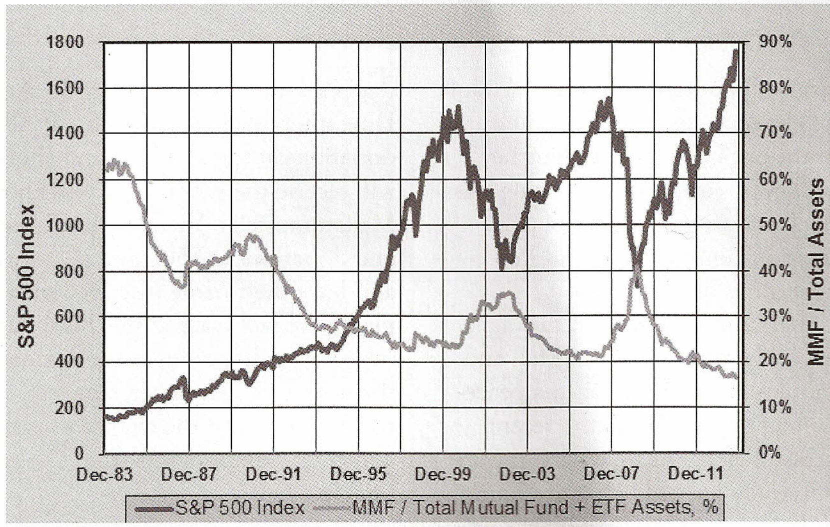
Professor Bernanke of Princeton was a leading scholar of the Great Depression. He knew how the passive Fed of the 1930s helped create the calamity – through its stubborn refusal to expand the money supply and its tragic lack of imagination and experimentation. Chairman Bernanke of Washington was determined not to be the Fed chairman who presided over Depression 2.0. So when turbulence in U.S. housing markets metastasized into the worst global financial crisis in more than 75 years, he conjured up trillions of new dollars and blasted them into the economy.... He didn't just reshape U.S. monetary policy; *he led an effort to save the world economy* [emphasis mine].



December 29, 2009

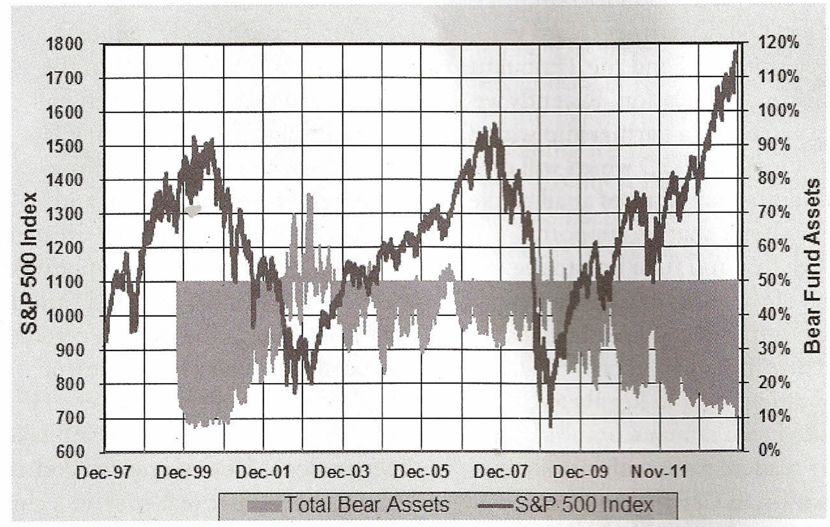
Economies do not need "saving." They need to be rescued from the toxic ideas of dead economists and committees of geniuses willing to turn them into grand experiments.

Figure 2 **Money Market Fund Assets/Total Mutual Fund + ETF Assets, 1984–2013**



Source: Investment Company Institute

Figure 3 **Rydex Total Bear Fund Assets/Total Bull + Bear Fund Assets, 1998–2013**



Source: Rydex Funds, www.decisionpoint.com